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10th Annual Wills and Estates Conference

THURSDAY 5 SEPTEMBER 2024

THE BOAT HOUSE BY THE LAKE

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5 September 2024

NAVIGATING THE TRANSITION

ESSENTIAL LEGAL STRATEGIES FOR BUSINESS SUCCESSION AND EXIT PLANNING

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Lawyers

Advice | Transactions | Disputes



Who is in the room?

Do you primarily practice in - (show of hands please)

- (a) Wills and Estates (but not estate litigation)
- (b) Estate Litigation (exclusively)
- (c) Both A & B
- (d) Corporate and commercial only
- (e) A mix of (a), (b) and (d) above?



Agenda

- Why is this topic important
- Australian businesses
- Understand the business
- Identify the value you can add
- Shareholder and Succession Agreement Key Elements
- Valuation metrics
- Exit payment logistics
- Dispute Resolution and experts
- **Close 11:35am**



Why is this topic important

Context, context, context

- PWC –global family business survey (2023)
 - 80% of Australian business owners surveyed indicated - protecting their business, as an important family asset, is the top priority.
 - 86% of surveyed businesses - some governance policy
 - BUT only 50% have a shareholders' agreement
 - This lack of formal governance can affect how a business is run and perceived, and its value over time.

This topic is important because

- To ensure a smooth transition, strong governance is critical
- To protect the value of our client's assets they must be managed in such a way as to provide for succession opportunities and minimise risk



This topic is important because

- Generational changes is upon us.
- slower rates of succession- older generations can find themselves in non-leadership roles, these challenges for business succession different to what they have been before.
- Percentage of female family business leaders is expected to rise from 22% to 50% over the next generation.

So what are we usually actually dealing with and talking about here when it comes to these businesses?...



Australian businesses

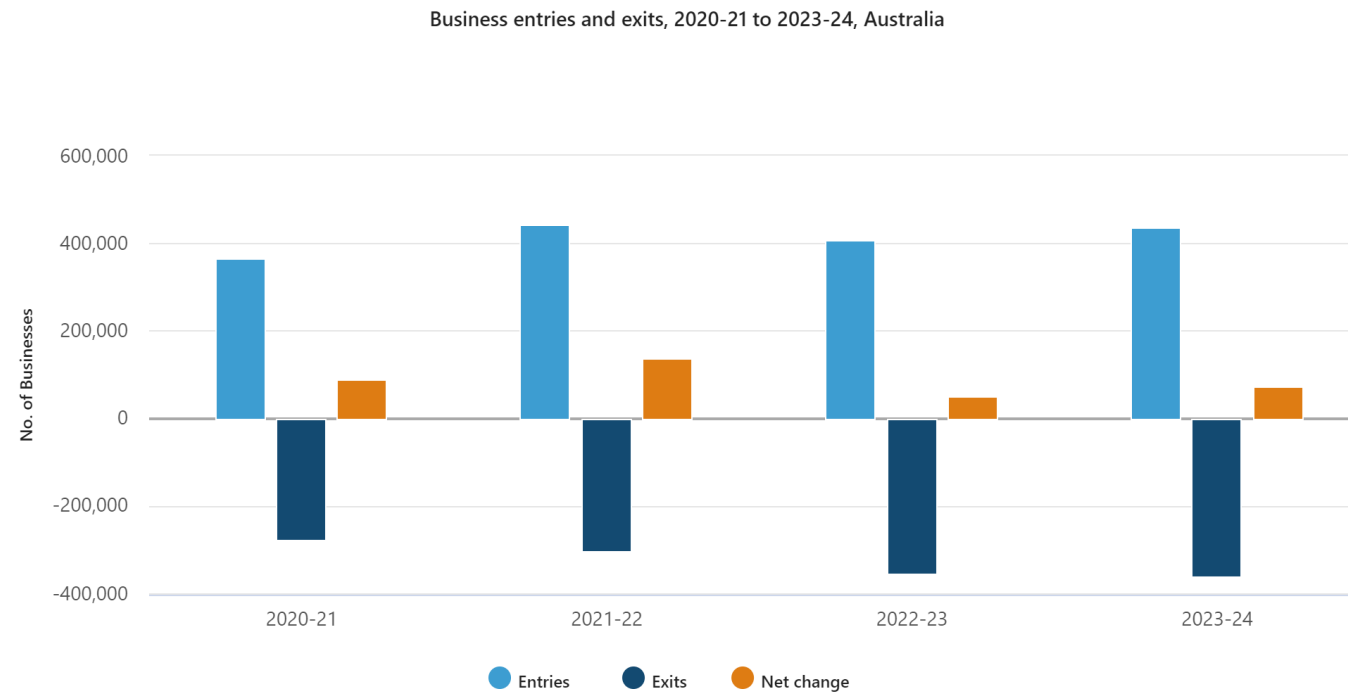
ABS 2024 data

■ **Key statistics**

- At 30 June 2024 there were **2,662,998** actively trading businesses in the Australian economy.
- In 2023-24 there was a:
 - 2.8% or **73,125 net increase in the number of businesses**
 - 16.8% entry rate, with 436,018 entries
 - 14.0% exit rate, with 362,893 exits

Australian businesses

ABS 2024 data cont.



Source: Australian Bureau of Statistics, Counts of Australian Businesses, including Entries and Exits July 2020 - June 2024

Australian businesses

What's booming

- In 2023-24 the three industries with the largest percentage increase in businesses were:
 - Transport and Warehousing (increase of 8.5% to 237,506 businesses)
 - Health Care and Social Assistance (increase of 7.7% to 199,763 businesses)
 - Financial and Insurance Services (increase of 4.8% to 129,031 businesses)
- Note: there were 1,217 new businesses recorded in Australian Capital Territory, being the largest percentage increase of the states and territories (equal with WA) at 3.5% of total

Australian businesses


Asset owning entities in business

- Sole traders
 - A person with legal or beneficial ownership of an asset who is also trading a business
- Companies
 - Now very common if not the most common, directors in charge of decision, shareholders own the shares
- Trustees of trusts and the trusts themselves
- Partnerships
 - Two or more people or trusts or companies operating in partnership

Australian businesses (and individuals)

Asset owning entities in business

- Sole traders

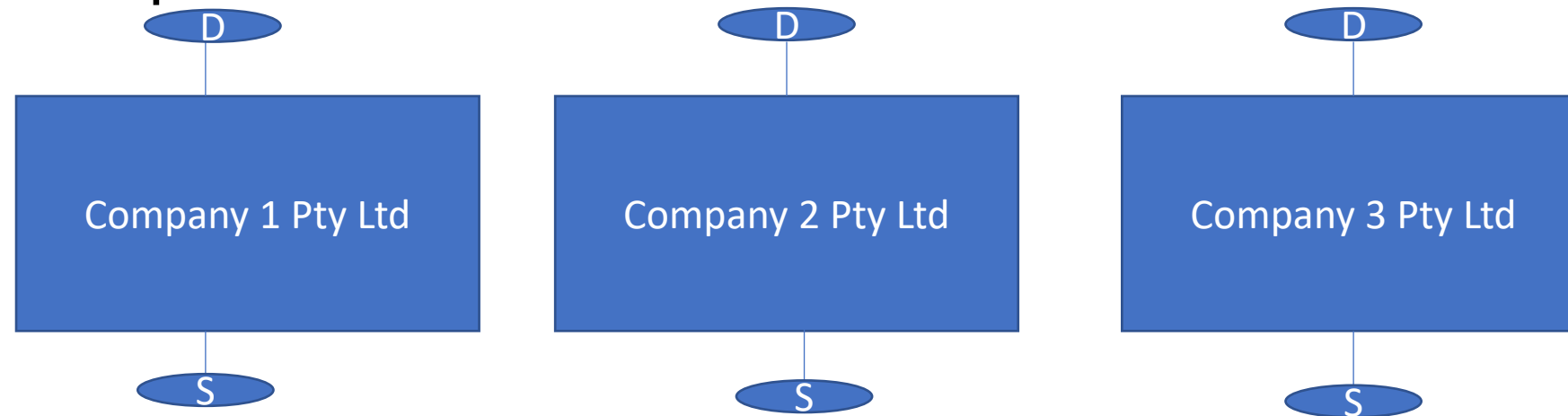


Sole trader
owns assets, employees people,
bears risk

Australian businesses

Asset owning entities in business

- Companies

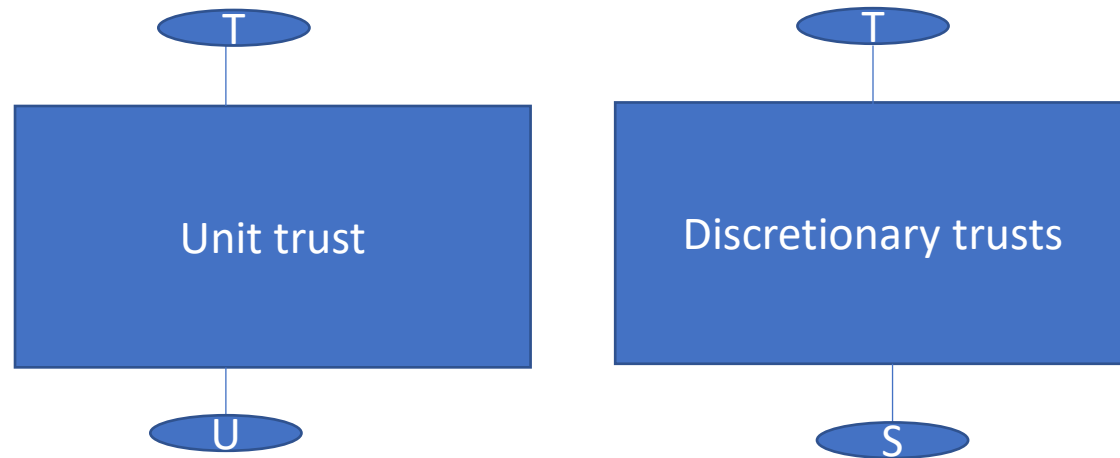


Commonly there will be some division between your client's asset owning vehicle, the employment vehicle and potentially a holding vehicle

Australian businesses (and individuals)

Asset owning entities in business

- Trusts



Where the trustee is a corporate, control of the trustee is by its directors, who are typically themselves controlled by the shareholders of the trustee

Australian businesses (and individuals)

Asset owning entities in business

- Multiple combinations of all of the above

Australian businesses

Popular structures in 2024

- In 2023-24 the ABS reported that total companies showed the largest net growth among types of legal organisations, with a 5.4% (58,688) increase to 1,153,149 businesses in total, with 185,819 entries.
- There was also a:
 - 4.1% (9,130) decrease in partnerships to 213,919 total
 - 2.4% (18,941) increase in sole proprietors to 803,687 total (so, despite the high degree of risk, the sole trader model remains very accessible)

Understand the business

Get the whole picture

- 1. The Accountant (who is it and can you have instructions to speak to them)
- 2. Ask for a structure diagram (from the client or the accountant)
- 3. Then – closely check the structure diagram using the tools we have access to:
 - ASIC extracts for company searches
 - Relational extracts
 - National property ownership searches / title searches / dealing searches (caveats, mortgages etc).
 - ABN Lookup
- 4. Balance sheets for all the relevant parts of the business

Understand the business

Get the whole picture

- 5. Understand how the money moves –
 - Where is revenue generated
 - Where do the costs in the business sit
 - Who owns the assets (are there assets the business needs which it does not own etc)
 - Number and type of employees
 - Employee share schemes
 - *Ask the questions*

Understand the business

Get the whole picture

- **5. Client conference, checklists, advisors**
 - What is it that the business needs to achieve –
 - Is it just about arrangements on business exits?
 - Is it a more broad question around structuring?
 - Seek views on the following (clients and advisors) -
 - Ask about the intended subject matter of the agreement – what will it deal with (directorships in any companies etc)
 - Trigger events
 - Transfer mechanism
 - Effect of the agreement
 - Purchase price for assets
 - Funding and payment

This is the opportunity to gather information and understand what the client knows and expects



Understand the business

Get the whole picture

▪ 6. Write a letter seeking instructions:

- You have asked us to prepare:
 - an agreement which dictates what is to occur to certain assets held by the Big Family Trust (“BFT”) and the Small Family Trust (“SFT”) upon the involuntary departure of either you or another (each a “Principal”) from the business.
- Subject matter of the agreement – what will it deal with
 - (shares in the trustee of the BFT and the SMF, directorships in any companies etc)
- Trigger events
- Transfer mechanism
- Effect of the agreement
- Purchase price for assets
- Funding and payment
- Should the arrangement take precedence (often, yes)

This is the opportunity to nail down what the client knows and expects you to do



Identify the value you can add

Protecting our client's wealth, and helping them to grow it, is our business

- While companies can exist in perpetuity, businesses, generally, do not.
- Providing some certainty to the inevitable exists from and entry to business, is an important way to structure and protect business viability.
- Think about who should be part of the conversation



Identify the value you can add

Who should be part of the conversation

- Are you going to act for the company, trust or partnership?
- If you are, who is properly empowered to instruct you?
- Once you are satisfied you have authority and know where instructions can come from – then consider who should be in the conversation

*In my experience this can be as controversial as the Conversations themselves



Identify the value you can add

Who should be part of the conversation

- If a company, the directors
- Are there issues you need to be aware of
- Can you create some stages to the work to facilitate managing the flow of information



Identify the value you can add

Next steps

- You have identified who can give you instructions and who will
- You've undertaken your enquiries as to the business, structures and relevant key players
- You can see a deficiency (or the client can) in the documents in place (if any) to best manage and provide for transition in the business

Shareholder and Succession Agreements

Shareholders Agreement – Key Matters for consideration

- If there is a company in the structure and it controls a business which is driving the accumulation of wealth – there simply must be a shareholders agreement in place.
- Where there is money, there is fertile ground for disputes.
- Don't accept the common 'everyone gets along' sentiment. Recommend a robust shareholders agreement if for no other reasons that to ensure 'everyone keeps getting along'. And, for your insurer.
- Shareholders Agreements (and company constitutions) - flex your creative legal mind – new share classes, redeemable preference shares and options over shares can all be used to implement solutions which will best suit your client's needs.

Shareholder and Succession Agreements

No one size fits all

- Shareholders Agreements - tailored but a strong template is a good starting point
- What next?

Shareholder and Succession Agreements

Shareholders Agreement – Key Matters for consideration

Key issues

- Value of shares – talk to the accountant, what calculation basis is best/fair/appropriate
- Right to appoint a director
- Drags, tags and takeovers
- Insurance
- Conditions on the transfer of shares
- The Board! Who is on it, what can they do, and how to they do it
- Distribution policies
- Restraints of trade / associated employment agreements

*Where a company is at the core of the wealth generation, it is critical the Shareholder's Agreement is given your thought, care and attention

What should the valuation metric be

Options

- There are options and the accountant should be actively involved
- As lawyers, we think about:
 - Market value
 - Fair value
 - Capitalised future earnings metrics
 - An earnings multiple
 - There are others, the ability to tailor – and it is important to get an understanding from your client as to how they ‘value’ the asset (whether it is an interest in a partnership, a shareholding etc).

Market v fair value

Market value – business or shares

- The High Court, in *Spencer v Commonwealth of Australia* [1907] HCA 82, identified principles to be followed in determining the ordinary meaning of market value.
- In valuing an asset, a valuer is to assume a market with hypothetical buyers and sellers and the 'market value', being the price negotiated between the buyer and seller to achieve a notional sale in the hypothetical market.
- The notional sale is assumed to be made after voluntary bargaining between a willing but not anxious seller and purchaser rather than a forced sale and with both being fully informed about the advantages and disadvantages of the asset being valued and aware of the current market conditions.

Market v fair value

Market value – business or shares

- *Spencer v Commonwealth of Australia* [1907] HCA 82
- “The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm’s length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion”.

Market v fair value

Fair value – business or shares

- **Fair value is not the same as market value for tax purposes**
- 'Fair value' is specifically used for financial reporting purposes. It is not always an identical concept to market value, although it is usually defined in a similar way.
- Australian Accounting Standard AASB 13 *Fair Value Measurement* defines fair value as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'.

Capitalised future earnings

For the value of the business

- The capitalised future earnings method is most commonly used to value businesses.
- When you buy a business, you're typically buying both its assets and the right to all profits it might generate in the future, which are known as future earnings.
- The future earnings are 'capitalised', or given an expected value. The capitalisation value gives the expected rate of return on investment (ROI), shown as a percentage or ratio.

An earnings multiple

For the value of the business

- Method helps compare different businesses, where the earnings before interest and tax (EBIT) are multiplied to give a value. The 'multiple' can be industry specific or based on business size.
- How it works
 - Find the earnings before interest and tax (EBIT) of the business
 - Seek advice from a business valuer for an accurate business earnings multiple
 - Multiply your EBIT by your multiple to find the business value
- For example, Katie wants to buy a sporting goods store. It has an EBIT of \$100,000 and an industry value of 2. This means she values it at \$200,000.

Further comments*

Redeemable preference shares

These valuation metrics work well for ordinary shareholdings

- However –
 - **The use of redeemable preference shares appears to be becoming more common**

When a company issues these shares they must include the circumstances in which the shares must, or can be redeemed. Some common examples include redemption at:

- a fixed time or on the happening of a particular event;
- the company's option; or
- the shareholder's option.

Further comments*

Redeemable preference shares

- The terms of the redeemable shares will also detail whether shareholders:
 - are entitled to cumulative or non-cumulative dividends;
 - have the right to vote; and
 - Where they stand in a winding up
- The terms of the redeemable shares will also dictate how and when the company can redeem them (redemption price).
- Or, if agreed (and resolved) the company can perform a selective buy back

Further comments*

Redeemable preference shares

- Use the shareholders agreement to manage how these shares can be disposed of by the shareholder –
 - 15.1 **Permitted Disposal**
 - (a) Subject to clause 15.1(b), clause 15.2 does not apply to a Disposal by a Shareholder:
 - (i) to a Related Entity or as required by clause 15.1(c);
 - (ii) that is approved by a Required Resolution of Shareholders; or
 - (iii) pursuant to clause 17 (**Exit**), clause 18 (**drag along**), clause 19 (**Cessation of employment**) or clause 20 (**Default**)

Further comments*

Redeemable preference shares

- Continue to use the shareholders agreement to manage how these shares are valued by the exiting shareholder –
 - 20.3 Default Purchase Price
 - During the 10 Business Days from the date a Default Notice is served under clause 20.2, the Defaulting Shareholder and the Non-Defaulting Shareholders must consult with each other with a view to reaching agreement on a market value for the Sale Shares and:
 - (a) if the Defaulting Shareholder and the Non-Defaulting Shareholders agree to a purchase price within that time, the purchase price for the Sale Shares is that price; or
 - (b) if the Defaulting Shareholder and the Non-Defaulting Shareholders cannot agree the price under clause 20.3(a), the Company will refer the matter to the Independent Valuer to determine the Market Value of the Shares in accordance with clause 22,
 - (Default Purchase Price).

Further comments*

Redeemable preference shares

- Where establishing the governing instruments, these arrangements can be implemented and tailored
- When dealing with an exit keep in mind whether the valuation metrics, drag and tag metrics and other relevant clauses relate to all securities or only to ordinary shares.

Right to appoint a director

The importance of control

The constitution of the modern corporation vests in its management the power to direct the resources provided by members for the members' ultimate benefit.

Right to appoint a director

The importance of control

- Directorships

Appointment and Removal

- (a) *Each Shareholder has the right to appoint (and remove or replace) one person as a Director [for each (30%) of the issued capital of the Company from time to time held by that Shareholder].*
- (b) *[Your board and/or member process for approval or removal]*
- (c) *Reference any disqualifying clauses which exist elsewhere in the agreement*

Right to appoint a director

The importance of control

- Directorships

Consider the right to appoint a replacement in the constitution or shareholders agreement

Check the conditions of the exercise of that right

Consider whether a replacement will have a positive impact on the company

Shareholder Agreement

Key Issues

- Drags, tags and takeovers
- Insurance (we will reach this later on)
- The Board! Who is on it, what can they do, and how to they do it
- Distribution policies
- Restraints of trade / associated employment agreements

Shareholder Agreement*

Even when documented – things can go awry

- Ideally, the dispute resolution clause deals with any controversy
- If not, litigation can follow
- An incomplete agreement or an error or internal inconsistency in a schedule (such as a form of transfer notice) can result in serious and expensive complications for all parties

Shareholder and Succession Agreements

Succession Agreement – Key Matters for consideration

Key issues

- Providing for the transfer of ownership on the happening of a certain event (death, TPD, Retirement)
- Think about the trigger events carefully – loss of a qualification, right to practice, adverse professional findings or convictions can be useful parameters for control
- Who gets the right/call option to buy the ‘exiting’ interest
 - Usually a strong succession arrangements gives the existing players the right to buy out the departing owner before bringing in new third parties
 - If there is no one interested in buying – think about options (wind up, silent partner, deferred payment arrangements etc)
- Insurance policies

Shareholder and Succession Agreements

Succession Agreement – ownership transfers

Key issues

- If a key person is to leave, does your client require another to take their place?
- If so, what timeframes would suit the business (with a view to minimising disruption to business activity at all times)
- Typically, the entity's Succession Agreement would either allow the existing owners to buy out the share and interest in the first instance, before offering that interest to third parties (as is the case with Shareholders Agreements)
- And the valuation metrics (derived from the same concepts we have already discussed) will be at play.

Shareholder and Succession Agreements

Succession Agreement – Trigger events

“due to death, serious illness or incapacity of the Management Shareholder, Management Shareholder's Nominee or spouse, child, grandchild, parent, grandparent or sibling”

The Trigger events **must be clearly defined**

Common triggers include:

- (a) Death
- (b) Total and permanent disability
- (c) Retirement (from the continued practice of a profession)
- (d) Insolvency or bankruptcy
- (e) Losing a professional entitlement to practice or a misconduct finding or conviction

Consider what length of absence from a business will constitute an exit

Logistics of the exit payment

When the time comes to pay

- Cash – easy (as long as the business has sufficient liquidity)
- Asset transfers (if agreed but model the tax consequences)
- Buy/sell insurance including
 - Self owned
 - Cross owned
 - Insurance trust ownership
 - Family trust ownership*
 - Company ownership*



Logistics of the exit payment

Insurance ownership

Who owns the policy	Why does it work well	What works less well
Self - ownership	Paid to departing owner or estate and business interest transferred to remaining owners	Need an effective buy/sell or succession agreement to facilitate
Cross ownership	Paid to remaining owners who pay to departing owner or estate as consideration for transfer of business interests	Same as above
Insurance trust ownership	trustee owns the policies on behalf of all the business owners multiple insurance policies may be owned by the trust administration of policies and premium payments are centralised. Suits large number of interest holders (partners, shareholders, unit holders) and where new interest holders are likely to be admitted.	Establishment of a special purpose insurance trust, to acquire the insurance policies and then distribute proceeds on the exit of a business owner in accordance with the terms of the trust deed. (If the trading entity is itself a trust or owned via a trust not be necessary to establish a separate trust structure)

Logistics of the exit payment

Insurance ownership

Who owns the policy	Why/where does it work well	What works less well
Family trust ownership*	each business owner's policies are owned by their own family trust	<p>Potential for tax implications in the hands of the recipient</p> <p>- The taxable income of a trust is generally taxed in the hands of the beneficiaries of the trust who are presently entitled to the distributable income of the trust by the end of the financial year. If the insurance proceeds are treated as trust capital then the recipients of the capital distributions should not be taxed on the taxable income of the trust. However, if the proceeds are classified as income of the trust then the beneficiaries may be taxed on the taxable income of the trust under the proportionate approach (as per section 97 of ITAA 1936). - CGT may be payable on TPD or crisis proceeds if a trustee has discretion and distributes the proceeds to an individual who is not the life insured or relative of the life insured.</p>
Company ownership*	Insurance proceeds paid to the company – option to buy departing interest	Potential for tax implications for the company

Use a tax law adviser

Why?

- Succession agreements and requests to restructure control can have significant tax consequences
- Market values are important
- Pre CGT assets need to be considered
- GST concessions are relevant

Why?

- Company v individual tax rates will affect outcomes
- Entity might have primary production land
- Overall – there is quite a lot to think about 😊

Dispute resolution

When things don't go to plan

- While we do our best, disputes can and will arise
- For the ongoing success of a business, there is generally a need for some speed
- Dispute resolution clauses should not themselves be the cause of lengthy delays or complications for the ongoing operation of the business

Who is a suitable expert?

The options are many and varied – however please note

- Most expert determination dispute resolution clauses (and expert determination clauses for valuation purposes) require parties to seek to agree on the expert; and
- if the parties cannot, either party may request a nominated third party (such as the president of an industry body) to appoint an expert

Who is a suitable expert?

Out with the old and in with the 'new'

- The old - President of the Institute of Chartered Accountants in Australia (ICAA) to nominate a suitable person
- The 'new' (since 2010 😊) - Institute of Arbitrators and Mediators Australia (IAMA) – identity impartial experts in the fields of finance and accounting.
- The President or Chapter Chairman of the IAMA will nominate a suitable financial expert. The expert will then determine the dispute in accordance with the IAMA's expert determination rules.

Distilling and discussing directors liabilities for the purposes of business succession

This is not an exhaustive list

The separation of ownership from control leaves open the possibility that management might divert those resources for its own benefit rather than that of the members, or fail to exercise the appropriate degree of care and diligence in the exercise of its powers. Recognising this possibility, the law seeks to provide members with adequate means of holding management accountable for the improper exercise of its powers.

- Breach of Director's Duties
- Shareholder Oppression remedies
- ACL remedies (misleading and deceptive conduct and persons involved in contraventions)

When it all goes wrong (or wasn't there to begin with)*

Discussion

Corporate group

Multiple business entities

100% owned by a holding co

Holding co owned 50/50 by two founders

One founder dies

No shareholder's agreement, no succession agreement

(Negotiation, effect on business value, winding up application, costs)

Long term thinking

Bringing it all together

- Sole traders – give the executor power to run the business or to engage someone to run (or sell) the business depending on the succession
- Directors – where the testator is a director, does the constitution or shareholders agreement permit a replacement director be appointed?

Long term thinking

Bringing it all together

- Know your client's business structure
- Talk through the who and when and the consequences of departure
- Succession Plans work but key individuals also need wills in order
- Take your time to understand the structures, where the assets are held, what the business does and who does it
- The process can be highly disruptive, even for established businesses
- communication is key

Q&A?

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